AP Macroeconomics
Test: International Economics
Instructor's Version

Answers: Free-Response Questions

1. Workers in the country of Andalia can produce either 10 tons of cheese or 20 tons of yogurt using a certain quantity of resources. With this same quantity of resources, workers in the country of Barragon can produce either 6 tons of cheese or 18 tons of yogurt.

   A. Which country has an absolute advantage in the production of these goods? Explain. (3 points)

   Answer: The country of Andalia.

   Explanation: Andalia has an absolute advantage because its workers can produce more of each good given the same quantity of resources.

   1 point for the correct country; 2 points for the explanation.

   B. Which country has a comparative advantage in the production of yogurt? Explain. (3 points)

   Answer: The country of Barragon.

   Explanation: The opportunity cost of producing yogurt in Barragon is 1/3 ton of cheese, while the opportunity cost of producing yogurt in Andalia is 1/2 ton of cheese. Because Barragon has a lower opportunity cost, it has a comparative advantage in the production of yogurt.

   1 point for the correct country; 1 point for the first sentence of the explanation; 1 point for the second sentence of the explanation.

   C. Who benefits most from trade between these countries? Explain. (3 points)

   Answer: Cheese consumers in Barragon and yogurt consumers in Andalia.

   Explanation: With trade, each country can specialize in the good it has a comparative advantage in. This specialization reduces prices for consumers of the goods that are traded.

   1 point for answer; 1 point for each sentence of explanation.

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D. What policy would benefit yogurt producers in Andalia? Explain. (3 points)

Answer: A trade protection limiting the export of yogurt from Barragon would benefit yogurt producers in Andalia. Answers could include a trade embargo or a high tariff on yogurt by Andalia.

Explanation: Without the import of yogurt from Barragon, Andalia must produce its own yogurt.

2 points for the answer; 1 point for the explanation.

2. Trade Policy

A. Explain why countries specialize in a production, and describe the effect this specialization has on international trade. (3 points)

Answer: Countries specialize to take advantage of comparative advantages. This increases trade with other countries. It also increases the well-being of everyone as a whole.

1 point for each sentence.

B. List the three reasons why a country might impose trade restrictions on another country. (3 points)

Answer:
1. To offset unfair competition from foreign producers
2. To retaliate against trade restrictions by others
3. For ideological reasons

1 point for each.

C. Describe the effect(s) of quotas. (3 points)

Answer: Quotas restrict imports by setting a numerical limit on the quantity of a good or service that may be imported. This benefits domestic producers but harms domestic consumers. It may also lead foreign producers to build their factories in other countries to get around import quotas.

1 point for each sentence.

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D. Explain how exchange rates are determined in an open-currency regime. (3 points)

Answer: In an open-currency regime, exchange rates are determined by the supply and demand for currencies. When demand increases, the price of that currency increases, and when demand decreases, the price decreases. Demand for a country's currency is determined by demand for that country's goods and services that must be purchased with that country's currency.

1 point for each sentence.

3. Monetary Policy and U.S. Trade

A. Explain why the value of the U.S. dollar would decline if the United States pursued an expansionary monetary policy. (5 points)

Answer: An expansionary monetary policy in the United States would lead to lower interest rates. As a result, foreign investment in the United States would decline. This happens because investors earn less with lower interest rates. With a reduced demand from foreign investment, there is a reduced demand for U.S. dollars. A reduced demand for a currency results in a lowering in the price of that currency.

1 point for each sentence.

B. When the value of the U.S. dollar declines, what effects does this have on the price of American-made goods, on the U.S. trade balance, and on the U.S. capital account? (5 points)

Answer: When the U.S. currency decreases in value relative to other currencies, this makes U.S.-made products relatively less expensive. This increases U.S. exports and decreases imports, reducing the trade deficit. With a decrease in foreign investment, the United States has less capital inflow and more capital outflow. But with increased exports and decreased imports, there is greater capital inflow and reduced capital outflow. This will keep the balance of payments equal to zero.

1 point for each sentence.

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4. Government Policy in an Open Economy

A. Describe the effects of an expansionary fiscal policy on trade and the exchange rate. (3 points)

Answer: An expansionary fiscal policy that increases the budget deficit drives up interest rates. It also drives up the price of the national currency. This causes the trade deficit to grow, and increased capital flows into the economy.

1 point for each sentence.

B. Describe arbitrage and explain what is necessary for arbitrage to work. (3 points)

Answer: Arbitrage is the act of making money by taking advantage of price differences. Arbitrage can only take place when the law of one price does not hold. There also cannot be trade barriers.

1 point for each sentence.

C. Explain the twin deficits effect. (3 points)

Answer: An increase in the government budget deficit will increase that nation's trade deficit. This occurs because an increase in the national debt crowds out private investment. This increases imports and decreases exports.

1 point for each sentence.

5. Who would be harmed and who would benefit if the United States imposed a high tariff on all imported toys? Explain. (2 points)

Answer: This would harm U.S. toy consumers because they would pay higher prices. It would benefit domestic toy producers because they would have less international competition and could charge higher prices and/or increase sales.

1 point for each sentence.

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